UNITED
NATIONS

E

Economic and Social Council

Distr.
GENERAL

E/C.10/1991/7
20 February 1991

ORIGINAL: ENGLISH

COMMISSION ON TRANSNATIONAL CORPORATIONS
Seventeenth session
10-19 April 1991
Item 6 of the provisional agenda*

ONGOING AND FUTURE RESEARCH

Determinants of foreign direct investment and their policy implications

Report of the Secretary-General

SUMMARY

The flow of foreign direct investment to host countries is determined by a wide range of factors. The Centre has undertaken a survey of the empirical literature on the determinants of such investment, in order to identify the main determinants, assess their relative importance, evaluate the impact of certain locational and policy factors on the flow of foreign direct investment and draw some implications as regards appropriate policies to attract foreign direct investment.

The most important determinants of foreign direct investment are the firm-specific assets that underlay the competitive advantages of transnational corporations, the ability of transnational corporations to gain from internalizing market relationships, the strengths of particular host countries as locations for foreign production by transnational corporations, and policies of host and home countries. Certain firm-specific assets may be the primary determinants of flows of foreign direct investment. Locational factors are important in determining where foreign direct investment occurs. Host country policies provide a necessary

* E/C.10/1991/1.

precondition for foreign direct investment, but effective policies by themselves are not enough to stimulate larger inflows of foreign direct investment.

Host countries can do little about firm-specific factors, but they can adopt policies to influence locational factors and to address specific policy aspects of the process by which transnational corporations decide on the location and size of their foreign production facilities.

CONTENTS

	Paragraphs	Page
INTRODUCTION	1 - 4	4
I. DETERMINANTS OF FOREIGN DIRECT INVESTMENT BY TRANSNATIONAL CORPORATIONS	5 - 30	6
A. Firm-specific factors	5 - 17	6
B. Locational factors	18 - 23	9
C. Policy factors	24 - 28	11
D. Relative importance of the various determinants	29 - 30	12
II. EMPIRICAL TESTING	31 - 38	12
III. POLICY IMPLICATIONS	39 - 50	14

INTRODUCTION

1. At its sixteenth session, the Commission on Transnational Corporations requested the Secretary-General to prepare a report on the research programme of the United Nations Centre on Transnational Corporations for consideration by the Commission at its seventeenth session. 1/ The Commission also requested the Secretary-General to prepare a report on ways of promoting foreign direct investment to developing countries. 2/ The present report has been prepared in response to those requests.

2. It is widely recognized that foreign direct investment has the potential to bring substantial benefits to host economies, in terms of capital inflows, transfer of technology and skills, employment, purchasing power, and linkages to the world economy. The growing recognition of the potential benefits has been reflected in the clearly discernible trend towards the liberalization of laws and regulations affecting foreign direct investment. The sizeable flows of foreign direct investment by transnational corporations - which grew by more than 300 per cent between 1984 and 1989, and reached a level of $200 billion in 1989 3/ - suggests the scope of these potential benefits.

3. However, the actual flow of foreign direct investment to host countries depends upon decisions undertaken by transnational corporations, which are determined by a myriad of factors. Understanding these factors, and their relative weight, is important for policy makers wishing to influence the decisions of transnational corporations regarding the location of their foreign production facilities. Frequently, the factors influencing the decisions of transnational corporations are of three types: firm-specific, locational or policy-based (see the table). 4/ The empirical evidence on the various factors influencing the foreign production decisions of transnational corporations are reviewed in section I of this report and evaluated in terms of their relative importance in determining flows of foreign direct investment. 5/

4. Certain firm-specific factors, especially the competitive strengths of individual transnational corporations, may well be the primary determinants for firms to decide to invest abroad. There is little a host country can do about firm-specific factors, but it can influence locational and policy ones. Accordingly, in section II, the report examines, on the basis of an empirical study, the impact of two key locational factors and a number of key policy variables. 6/ While that analysis shows that locational factors are particularly important in determining flows of foreign direct investment, appropriate policies provide a necessary precondition for foreign direct investment, even though they may not be sufficient by themselves to influence transnational corporations in their locational decisions. In section III, therefore, a number of conclusions are drawn as to the considerations host Governments may wish to keep in mind, and policies they may wish to pursue, if they should desire to influence the determinants of the allocative decisions of transnational corporations.

Table. Principal determinants of foreign direct investment

Category	Determinant
Firm-specific	Technological assets, usually measured by research and development intensity
	Product differentiation and marketing skills, often measured by advertising intensity
	Management skills
	Production efficiencies - e.g., multiplant operations, scale economies
	Size and concentration
	Ease of internalizing returns from ownership advantages
	Access to capital
Location	Size of host country markets
	Production costs, including labour costs and productivity
	Transport costs, exchange rates and trade barriers
	Natural resource availability
Policy	Efficiency of administrative apparatus
	Domestic economic stimulation
	Investment incentives and performance requirements
	Openness to foreign ownership
	Repatriation policies
	Fiscal régime

I. DETERMINANTS OF FOREIGN DIRECT INVESTMENT BY TRANSNATIONAL CORPORATIONS

A. Firm-specific factors

5. Foreign direct investment is undertaken by transnational corporations, and the analysis of the determinants of foreign direct investment is largely an analysis of the forces that shape decisions by transnational corporations and how they interact with market conditions, including conditions within potential host countries. Research on the determinants of foreign direct investment by transnational corporations has focused on identifying which firm-specific assets, both tangible and intangible, are most important in shaping those decisions.

1. Ownership advantages

6. High levels of research and development often give firms a head start in exploiting the commercial potential of new ideas. In addition, technological superiority is one of the factors giving transnational corporations competitive advantages in world markets. The research intensity of production has been found to be an important variable in determining foreign direct investment. In general, industries and firms with high degrees of research intensity both tend to have higher levels of foreign direct investment, or have a higher proportion of their production located in foreign countries than industries and firms with lower degrees of research intensity.

7. Transnational corporations also have a competitive advantage to the extent that their work force possesses strong managerial and technical skills. The possession of such skills can be seen as an aspect of the technological advantages of transnational corporations. At the same time, managerial and technical skills can provide a channel for the dissemination and co-ordination of technological and other advantages within a firm that is independent of the level of research-and-development spending. Although such skills are sometimes difficult to measure, research has indicated that the presence of such skills helps explain foreign direct investment flows. 7/

8. Marketing skills, brand-name recognition and other aspects of product differentiation also contribute to a transnational corporation's ability to produce profitably in foreign locations. These factors are, of course, most important for transnational corporations that are producing in host countries in order to be close to local markets. Marketing and brand recognition are examples of intangible assets that are difficult to transfer successfully to other enterprises. Brand names can, of course, be transferred via licensing and franchising arrangements, but such arrangements frequently include close involvement by the corporations owning the brand name, in order to protect the value of their intangible asset. Again, measuring such intangible assets is difficult; research utilizing advertising outlays by transnational corporations as a proportion of their sales has found this factor to be positively related to flows of foreign direct investment. 8/

9. Production efficiencies which are transferable to new locations help a corporation in its foreign production. The experience of United States firms in managing multiplant operations within their large internal market is one factor behind the success of United States-based transnational corporations as foreign producers in manufacturing industries. A prominent example of this phenomenon is the foreign direct investment by Ford (United States) before the First World War. 9/ Similarly, firms with experience in multiplant operations have found that experience to be beneficial in competing within the United States. It is possible that this factor will contribute to successful foreign direct investment within the European Community after the establishment of the single market at the end of 1992.

10. To the extent that economies of scale result in greater centralization of production in some industries (probably where such economies are dynamic, so that higher levels of output lead to new forms of cost-cutting), there might be less foreign direct investment and greater tendency to utilize exports for penetrating foreign markets. In industries where the limits of economies of scale can be reached, as in many durable goods industries, an initial tendency towards centralization might be offset by the need to construct new capacity as initial scale economies are reached. Foreign direct investment might be promoted in cross-national, regional markets. This seems to have happened with foreign direct investment by United States-based automobile corporations in their manufacturing and assembly operations in Western Europe.

11. The size and relative market power of transnational corporations is another important determinant of their foreign production decisions. 10/ Large firms may be more likely to possess the tangible and intangible assets conducive to obtaining competitive advantages in host country markets, while firms that have a dominant market position in their home country markets may use those same skills to obtain dominant positions in host country markets. Large firms may also have easier access to capital. In addition, the nature of oligopolistic competition may stimulate foreign direct investment. If a market leader in a home country engages in foreign direct investment, its competitors may follow, in an attempt to prevent the first firm from using its host country advantages to improve its home country competitive position.

12. Evidence indicates that both firm size and concentration are positively related to foreign direct investment. However, such factors need to be evaluated carefully. Size and high concentration can lead to inefficiencies - for example, where size is not accompanied by effective managerial networks or where concentration leads a corporation to underestimate its potential competitors and downgrade new technology. Concentration can lead to a firm's dissipating the advantages it possesses from its tangible and intangible assets. In addition, the growth of foreign direct investment by small and medium-sized transnational corporations in developed market economies raises the importance of evaluating how companies gain competitive advantages in foreign markets through exploiting niche production and how economies can emerge in smaller-scale operations.

13. The role of niche production appears to have been important in explaining foreign direct investment into the United States before 1980, since the market power of United States producers tended to act as a barrier to many potential

foreign investors. Since 1980, the growing ability of transnational corporations from Japan and Western Europe to compete internationally has been reflected in increasing foreign direct investment into the United States by a large number of foreign firms. Niche production may also play a role in the growth in recent years of foreign direct investment by small and medium-sized transnational corporations. 11/

2. Internalization advantages

14. From the standpoint of the organization of production, the rapid growth of foreign direct investment relative to output or international trade leads to a larger proportion of international production carried out via the internal arrangements of transnational corporations, rather than as arms-length transactions in markets. The application of firm-specific assets to production in foreign locations can lead to the cross-border internalization of market transactions. Internalization is often preferred to arms-length or intermediate relationships by transnational corporations because it allows greater control over a vertically integrated and global chain of production and potentially provides a larger scope for realizing economies within the production process and earning profits on invested capital. However, internalized production may be most effective in the presence of certain firm-specific assets and is not necessarily a preferred strategy for all transnational corporations.

15. Foreign direct investment is usually taken to be the most important measure of the growth of transnational corporations. However, transnational corporations also expand through the use of non-equity arrangements, such as subcontracting, franchising, joint ventures, research consortia and technology transfer agreements. 12/ Thus, in addition to there being a quantitative aspect of transnationalization, there is also a qualitative aspect, as indicated by the expansion of non-equity arrangements. Complete and accurate data are not available on the extent and growth of such arrangements, and future research on the growth and impact of this dimension of the scope of transnational activity by transnational corporations would be desirable. Available evidence indicates that the use of non-equity arrangements by transnational corporations grew substantially in the 1980s. Much of this growth involved arrangements between transnational corporations and firms in other developed market economies and it is not clear whether the growth of non-equity arrangements in developing countries was able to compensate for the shifting balance of foreign direct investment in favor of the developed market economies.

16. The growing use of non-equity arrangements by transnational corporations involves an "unbundling" of the components of foreign direct investment. When production is undertaken by wholly owned affiliates of transnational corporations, the corporation puts forward the capital, technology and management, bears the risk and receives the returns. With non-equity arrangements, the transnational corporation and its host country partners put forward inputs in different combinations and similarly share risks and returns. In general, transnational corporations will seek to retain control over those elements of production where the ownership-derived rents are greatest; this frequently means that transnational

corporations will enter non-equity agreements when they feel they can gain substantial returns from a proprietary technology but where they assess the potential returns from controlling production and distribution to be of a lesser order. 13/

17. The growth of non-equity agreements is partly due to the attempt by transnational corporations to reduce their international exposure and reduce their risks. Regulations in developing countries that restrict asset ownership by foreign transnational corporations have also led to a greater interest in non-equity arrangements. For developing countries, such arrangements can be beneficial, since they involve host country institutions more closely with production. They also distribute more of the risk to the host country, require more capital to be raised in the host country, and may result in a reduction in technology transfer, to the extent transnational corporations are reluctant to transfer proprietary technology to host country partners. The growing flexibility being exhibited by transnational corporations in choosing the mechanism by which they engage in international production suggests that developing countries also need to be flexible and consider a variety of alternative approaches to the regulation of transnational corporation activity.

B. Locational factors

18. The competitive advantages attributed to the owned assets of transnational corporations are not sufficient to explain why foreign direct investment occurs in any given location. Foreign direct investment is also determined by the economic conditions within prospective host countries and how those conditions can be combined with the ownership advantages possessed by transnational corporations. Market size is the most important locational determinant of foreign direct investment. Transnational corporations tend to favour production locations in large foreign markets, since selling in large markets provides a ready means of recouping investments. The growth rate of foreign markets is less important as a determinant of the location of foreign direct investment, perhaps because the bulk of foreign direct investment is for the initial establishment of affiliates. Changes in growth rates may help determine the rate of expansion on an affiliate, but its establishment is more likely to be dependent on the long run size of the market, not short term fluctuations in growth rates.

19. A second important locational determinant of foreign direct investment is cost. Differences in relative unit labour costs have been found to be a determinant of foreign direct investment in some studies but not in others. 14/ This factor appears to be important largely in the case of export-oriented offshore production, and even there, it is one of a number of determinants of foreign direct investment. Changes in production technology and the organization of production have made labour costs less important in many industries and have made it more economical to locate both intermediate production and final assembly of many goods closer to their final markets. These changes have reduced some of the advantages possessed by developing country production locations.

20. Additional locational factors, such as tariffs and other trade barriers, transport costs and exchange rates, have been found to contribute to the determination of foreign direct investment flows in some instances, but not generally. Trade barriers can influence the choice between exporting to a host country and producing within the host country. The ability to exploit firm-specific advantages, however, appears to be the most important factor behind such choices. Similarly, a falling exchange rate can make a host country's assets more attractive to a potential foreign investor, but if the exchange rate is expected to fall further, it can act as a disincentive to prospective investors. To the extent that transnational corporations see themselves as long-term investors, exchange rate movements may have little impact.

21. Sectoral differences are also potentially important in distinguishing among alternative host countries. Much empirical research on the determinants of foreign direct investment is conducted at an aggregate level, due to data availability, and is unable to distinguish among the various sectoral-specific locational factors. Natural resource availability would obviously be important in determining the location of foreign direct investments in industries that are heavily dependent on natural resources, such as petroleum. Access to natural resources and their cost has been found to contribute to the determination of foreign direct investment in some empirical studies, but not in others. The availability and cost of natural resources can also contribute to locational advantages in the case of foreign direct investment in manufacturing industries, depending upon the importance of the resources to the production process and whether there are significant advantages accruing to the investing firms from locating some portion of their manufacturing operations in proximity to the source of natural resources. Costs can influence locational decisions for export-oriented foreign direct investment in manufacturing. For most manufacturing operations, however, the size of the local market is the primary determinant.

22. There are also locational differences with respect to foreign direct investment in services, but again most empirical research has not succeeded in distinguishing locational advantages in services from locational advantages for foreign direct investment in general. Some services, such as those associated with tourism, would be more closely linked to some potential locations than to others; many services, however, are linked with other aspects of production and, with improvements in data technology, can be located in many different potential host countries. Thus, size of market and the strength of linkages with the international networks of transnational corporations can provide locational advantages in some situations. For services that must be delivered at the point of production, such as trade and real estate, the host country regulatory environment is important. 15/

23. The continuing decline in the share of world-wide foreign direct investment flows going to developing countries indicates that transnational corporations are increasingly locating their foreign production facilities within the developed market economies. This shift is partly due to the changing importance of locational advantages of developed and developing economies. Technological and organizational changes in production that have tended to reduce the importance of raw materials and unskilled and semi-skilled labour in the production of a wide

range of goods and services have also worked to the disadvantage of many host developing countries. At the same time, the competitive strategies of transnational corporations have increasingly emphasized the location of production in or close to the major markets in Japan, North America and Western Europe. 16/ While foreign direct investment has grown significantly in some host developing countries, the growth has tended to be concentrated in countries with large internal markets, newly industrializing countries with sufficient skilled labour and the ability to absorb new technologies, and countries in geographical proximity to the large developed country markets. Thus, the locational advantages of developing countries have not been sufficient - in general - to compensate for changes in corporate strategies and the important locational advantages of the developed market economy countries.

C. Policy factors

24. Transnational corporations are also concerned with political conditions and regulatory and legal environments within potential host countries. Transnational corporations frequently state that political stability is an important precondition for undertaking foreign direct investment. In practice, however, various measures of violence and political instability have not been important as determinants of foreign direct investment, perhaps because transnational corporations and Governments have been able to offset th potential negative influence of such factors.

25. When undertaking foreign direct investments or engaging in non-equity investments, transnational corporations must deal with host country administrative arrangements. A large number of countries have taken steps to simplify the entire process whereby investments are approved, which can lower costs for both host countries and transnational corporations, and reduce uncertainty for potential investors. Some developing countries have instituted "one-stop" procedures, where transnational corporations can obtain all necessary approvals in a single office with a minimum of paper work. Another example is the adoption of "negative lists", whereby all industries of a host economy are open to foreign direct investment except those explicitly listed.

26. Many countries have long had policies that sought to regulate the entry and operations of transnational corporations. These regulations include keeping certain industries closed to foreign participation, limiting foreign ownership of domestic corporations, "fade out" provisions which require that foreign owners withdraw their ownership interests, and limitations on the reinvestment of profits.

27. A number of host countries have sought to affect investment decisions by transnational corporations directly through the use of investment incentives. Most such incentives fall under the heading of tax relief or direct subsidies but could also include tariff protection, credit assistance or other inducements granted by Governments.

28. Host countries have also tried to influence the economic impact of foreign direct investments through the establishment of performance requirements, such as

local content requirements or the requirement that an affiliate of a transnational corporation located in a developing country must export a minimum proportion of its output.

D. Relative importance of the various determinants

29. The primary determinants for a firm to decide to engage in foreign direct investment are firm-specific factors. In particular, a survey of the empirical literature on the determinants of foreign direct investment indicates that three ownership advantages are the most important:

(a) Research and development intensity, as a measure of technological creativity and the importance of product and process innovation in maintaining the competitiveness of the transnational corporation in global markets;

(b) Advertising intensity or other measures of marketing skills and product differentiation;

(c) Management expertise, both quantitative and qualitative.

30. The ability of transnational corporations to exploit ownership-specific advantages and to manage a chain of internalized production processes appears to be the predominant explanation of the size of foreign-direct-investment flows. Decision by transnational corporations as to where to locate their foreign production facilities are governed both by the strengths of transnational corporations and by conditions and policies in specific locations. Market size is the most important factor in determining the location of foreign direct investment. The empirical literature indicates that resource availability and production costs, and especially labour costs, are important in certain situations. In addition, effective policies, a necessary precondition for foreign direct investment, are also important in specific situations.

II. EMPIRICAL TESTING

31. As indicated above, firm-specific factors appear to be the most important determinants of the volume of foreign-direct-investment flows. The specific location of foreign direct investment, however, is influenced by the differing locational advantages of alternative host countries and by the policy environment in specific host-country locations. In order to evaluate what difference, if any, location-specific factors and the policy environment make to determining the direction of flow of foreign direct investment, the Centre undertook an empirical analysis, focusing on foreign-direct-investment flows in the late 1970s and into the 1980s.

32. During the 1980s, a large number of countries changed policies and regulations affecting transnational corporations. In many cases, especially in developed market economies, the changes were a component of policies aimed at improving the climate for business operations in general and did not single out the activities of

transnational corporations. For example, privatization of previously government-owned assets in developed market economies frequently applied to both domestic firms and foreign transnational corporations. In other cases, primarily in developing countries, the changes were part of explicit attempts to attract greater amounts of foreign direct investment by transnational corporations, to influence the impact of foreign direct investment. Some countries have reduced or removed their exchange controls, permitting wider currency convertibility and allowing greater repatriation of profits and dividends. Price controls have been eased or lifted, giving greater play to market forces. A growing number of countries are utilizing investment promotion programmes as a means of attracting export-oriented foreign direct investment. 17/ As with most of the policy changes discussed above, these also represent moves designed to reduce the restrictions on the activities of transnational corporations and attract greater amounts of foreign direct investment.

33. For example, conditions restricting the entry of transnational corporations into key industries were reduced and new investment codes were formulated which made regulations more flexible. The changes contributed to improving the climate for foreign direct investment in a number of developing countries, including the Republic of Korea and China. Changes in performance requirements in the 1980s were in the direction of imposing greater restrictions on transnational corporations. However, the incidence of performance requirements is not high. Moreover, performance requirements represent the only major area of policy where changes were in the direction of greater restrictions.

34. Data collected by the Centre on policy changes affecting foreign direct investment by transnational corporations for 46 countries (20 developed market economy countries and 26 developing countries, including five newly industrializing countries) over 11 years (1977-1987) illustrate the scope and direction of the changes. 18/ The data include more than 300 instances of changes in policies and regulations affecting foreign direct investment by transnational corporations, with more than two thirds of the changes in the direction of reducing restrictions on the activities of transnational corporations. In the case of the newly industrializing countries, more than three fourths of the changes were in the direction of reducing restrictions on transnational corporations. Similarly, in the period from 1977 to 1987, more than three fourths of all policy changes involving ownership regulations resulted in a lowering of the restrictions on ownership by transnational corporations in host developing countries.

35. Despite substantial changes in policies, flows of foreign direct investment to developing countries have increased only slightly, and the increases have tended to be concentrated in the largest and most rapidly growing developing countries. 19/ Thus, policy changes may have a limited impact by themselves. In developing countries that possess a large and growing internal market or substantial productive resources and in countries that are in geographical proximity to a major developed country market, changes in policies and regulations can be instrumental in helping attract greater amounts of foreign direct investment. This appears to have been the case in China, India, the Republic of Korea and recently in Mexico.

36. Ongoing research at the Centre has attempted to evaluate the impact of policy changes on foreign-direct-investment flows to developing countries using statistical techniques. The more than 300 examples of policy changes in the period from 1977 to 1987 were coded, to reflect whether they represented changes towards greater restrictions on foreign direct investment, a lessening of restrictions on foreign direct investment, or were neutral in their projected impact upon foreign direct investment. The coded policy changes were then used statistically to explain changes in flows of foreign direct investment. In addition, measures of host country gross national product, host country exchange rates and political risk ratings, variables designed to measure other determinants of foreign-direct-investment flows, were included in the statistical tests. For most countries, and especially for the developing countries, the policy changes explained very little of the observed changes in foreign-direct-investment flows. For the developing countries in the sample, except for the newly industrializing countries, the policy changes explained almost none of the flows of foreign direct investment. Instead, the size of host country markets was the most important determinant in the analysis. In the sample of newly industrializing countries, extensive policy liberalization was accompanied by significant augmentation of foreign-direct-investment inflows, indicating that the policy changes enhanced the growing attraction of those countries as hosts to foreign direct investment.

37. Statistical analysis of the type undertaken in this research is limited in its ability to provide definitive answers. For example, the method of coding policy changes is not able to distinguish whether one type of policy change is more important than another. Changes in the implementation of existing policies are not measured, and such changes may be more important than alterations in the policies themselves. It is difficult to measure the lag between when a policy is changed and when market responses occur. In addition, it is easier to obtain measures of certain possible explanatory variables than of others. Future research on this issue may have to explore new data and seek measures that can discriminate among various policy instruments.

38. At the same time, the statistical results are consistent with research on the behaviour of transnational corporations, which indicates that basic economic conditions are the most important determinant of where transnational corporations engage in foreign production and of how much capital they transfer to their foreign production locations. However, for a number of specific issues there remains substantial scope for future research. One issue worthy of attention is whether the determinants of foreign direct investment have been reasonably stable over time or whether there have been important changes in their relative importance.

III. POLICY IMPLICATIONS

39. The evaluation of the determinants of foreign direct investment and the analysis of recent experience with policy liberalization indicate that the strengths of transnational corporations and the advantages of particular locations are the most important factors determining the size and location of flows of foreign direct investment. Host countries cannot affect the firm-specific factors that determine foreign direct investment. But host countries can affect their

general economic environment, and they can seek to fit their policies to their economic strengths.

40. To give one important example, evidence on the effect of investment incentives has in general not supported the view that those measures have been particularly effective in expanding the flow of foreign direct investment to developing countries. 20/ There is evidence of effectiveness in host countries under certain conditions. Tax incentives can influence locational decisions for transnational corporations that are seeking to export back to their home country, when the different locations under consideration are roughly equal in terms of other criteria, while import protection can serve as an inducement for firms seeking to serve the local market. In both cases, however, these inducements are one among a number of factors that transnational corporations must consider in making their locational decisions. Moreover, the granting of such inducements are not cost-free to the host country. For example, import protection may attract less efficient investors and deprive the host economy of the opportunity to attract producers with more up-to-date technology. The interventions that are most successful tend to improve the efficiency of the use of resources within the host country. They tend to be associated with a fuller utilization of economies of scale and a subjection of individual projects to competitive forces. The more successful interventions are frequently aimed at overcoming the reluctance on the part of potential investing transnational corporations to bear the costs and uncertainties of relocating or redesigning their facilities.

41. Choosing policies necessarily involves a careful weighing of alternatives. It is difficult, however, to judge when interventions can be effective in meeting host country objectives. With regard to incentives, host developing countries can find themselves in competition with other developing countries as potential locations for foreign direct investment and feel they must offer incentives to remain competitive. In such a situation, transnational corporations may benefit from the incentives without changing their location decisions. Host developing countries can seek greater co-operation with other developing countries towards harmonizing laws and regulations regarding transnational corporations, in order to avoid situations where countries bid against each other for foreign direct investment.

42. The greater integration of national economies within a single region can increase the size of the market that can be served from any given production location. The pending integration of the economies of the European Communities (EC) through the single market programme has attracted greater foreign direct investment from Japan and from countries thoughout Western Europe; transnational corporations from the United States, many of which already have a substantial presence within one or more of the member countries of the EC, have not expanded as rapidly. Integration within North America has not, to date, led to large increases in foreign direct investment, although the possible inclusion of Mexico in a larger North American free trade region has stimulated greater activity on the part of transnational corporations in that country. Regional integration among developing countries has not led to larger inflows of foreign direct investment, perhaps because other factors, such as levels of economic development or the debt crisis, were more important in determining the attractiveness of specific locations to foreign direct investment. 21/

43. Reducing administrative and regulatory barriers to foreign direct investment, providing fiscal incentives, opening host economies to freer flows of trade and currencies, and other policy moves will help provide a climate to promote foreign direct investment. Indeed, such policies can be seen as a necessary precondition to attract foreign direct investment. However, research on the determinants of foreign direct investment indicates that an appropriate policy climate is not enough. Policies do not appear to be sufficient by themselves to stimulate significant additional inflows of foreign direct investment by transnational corporations. Thus, the most important policies a host country can undertake may be those that provide incentives for the development of a skilled labour force, including managerial and technical workers, and those that contribute to a growing domestic market. Moreover, as the policy and regulatory framework with respect to foreign direct investment is more conducive to attracting greater inflows of foreign direct investment to developing countries, the payoff from further improvements will not be very large. Instead, it might be desirable to place greater emphasis on the economic factors that contribute to the locational advantages of host developing countries. In this regard, policies towards foreign direct investment might be most effective if they are formulated as part of a broader set of policies designed to provide long-term stimulation to the host country's economy. Similarly, since it is the economic and social benefits derived from foreign direct investment that is most important for host countries, policies towards foreign direct investment that are a component of general economic policies are also likely to contribute to improving the quality of foreign direct investment, and not only its quantity.

44. The importance of firm-specific advantages in determining flows of foreign direct investment and the inability of host countries to affect these advantages do not mean that host developing countries should ignore the characteristics of transnational corporations. Investment promotion efforts can be utilized to match the competitive advantages possessed by transnational corporations more closely with the locational advantages of host countries. In the case of small and medium-sized transnational corporations, many of whom have less experience in organizing international production than large transnational corporations, investment promotion efforts by host developing countries can help reduce the costs associated with foreign direct investment and help companies realize the benefits of their firm-specific advantages.

45. One area where local resources are important is technology. The increasingly important role being played by technology in economic growth has been accompanied by increasing attention to the transfer of technology on the part of developing countries. In the past, some countries, perhaps most prominently in the case of the Republic of Korea, have been successful in importing technology while simultaneously restricting the inflow of foreign direct investment by transnational corporations. More recently, however, in recognition of the important role technology is assuming in all phases of the value-added chain, from production to assembly to distribution, the Republic of Korea has formulated policies to encourage greater inflows of foreign direct investment. 22/

46. An important issue is whether developing countries have the capacity to absorb and apply the new technological and organizational methods to production by national firms. Among developed economies, Japan represents an example of the successful application and adaptation of imported production technologies; among developing countries, the Republic of Korea has had similar success. 23/ In both examples, the transfer and resulting transformation of production technology was eased by the relatively high level of education and skills available in the importing country and the existence of institutions in both the private and public sectors capable of providing the training needed over time. Unless similar conditions exist, it may be difficult to replicate in other countries the experience of the Republic of Korea and Japan.

47. Policies of home countries can also contribute to stimulating flows of foreign direct investment to developing countries. Many home countries have programmes to provide assistance to transnational corporations in their foreign-direct-investment activities, including, for example, protection of investments and dissemination of information. In addition, some home countries provide direct financial support to transnational corporations to encourage investment in developing countries. 24/ A study of the programmes undertaken in Germany indicates that they contributed to stimulating foreign direct investment from Germany to developing countries. 25/ Thus, it appears that home countries can contribute to increasing the flow of foreign direct investment to host developing countries.

48. To the extent that the formulation of policy relies upon the analysis of the factual situation regarding the determinants of foreign direct investment, it is necessary for information and research results to be continually refined and evaluated. To that end, the research programme of the Centre contains a number of projects that promise to contribute to the state of knowledge regarding the determinants of foreign direct investment and the possible effectiveness of different policy initiatives.

49. As a component of its ongoing research, the Centre will be providing, on a continuing basis, information on both flows and stocks of foreign direct investment for both home and host countries. In addition to preparing a comprehensive compendium of data on transnational corporations, the Centre is devoting resources to improving data collection and upgrading the quality of available information. In a similar vein, the development of more sophisticated measures to track and evaluate policy changes is an objective of ongoing research on policies towards foreign direct investment. This research effort is examining the context in which policy changes have occurred, how the application of existing policies might have changed over time, what impact they have had on the flow of foreign direct investment and what policy implications flow from there.

50. National policies towards intellectual property rights have been emphasized in a number of international fora. Changes in such policies have emerged as a possible lever by which host developing countries can affect the location and the quality of foreign direct investment. Ongoing research on intellectual property rights will analyse policy initiatives undertaken by host countries and their impact upon flows of foreign direct investment. Another policy issue of importance is the move towards greater regional economic integration, most prominently in the

example of the single internal market within the European Community. As part of the Centre's evaluation of the role played by transnational corporations in economic integration, the Centre is conducting a survey on the expectations of transnational corporations regarding changes within the European Community and on the motives regarded as most important by transnational corporations as they make decisions on the location of production facilities for the new economic conditions in Europe. The use of survey techniques will allow the development of new sources of data, and provide the background for similar efforts in the future.

Notes

1/ Official Records of the Economic and Social Council, 1990, Supplement No. 7 (E/1990/26), para. 101.

2/ Ibid., p. 4.

3/ For a more complete discussion of recent data and trends in foreign-direct-investment flows see "Recent developments related to transnational corporations and international economic relations: the triad in foreign direct investment" (E/C.10/1991/2). For earlier data, see Transnational Corporations in World Development: Trends and Prospects (United Nations publications, Sales No. E.88.II.A.7).

4/ See John Dunning, Explaining International Production (London, Unwyn Hyman, 1988), chap. 2.

5/ See "The determinants of foreign direct investment: a survey of the evidence", paper prepared for the United Nations Centre on Transnational Corporations, 1990.

6/ See "Do government policies towards foreign investment matter?", UNCTC Current Studies, Series A (forthcoming).

7/ S. Lall, "Monopolistic advantages and foreign investment by U.S. manufacturing industry", Oxford Economic Papers, No. 32 (March 1980), pp. 102-122.

8/ R. F. Owen, "Inter-industry determinants of foreign direct investments: a Canadian perspective", in New Theories of Multinational Enterprise (London, Croom Helm, 1982), A. M. Rugman (ed.); N. Kumar, "Intangible assets, internalisation and foreign production: direct investments and licensing in Indian manufacturing", Weltwirtschaflifches Archiv, No. 132 (1987), pp. 325-344.

9/ See, e.g., George Maxcy, The Multinational Motor Industry (New York, St Martin's Press, 1981).

10/ The importance of firm size and market power in the international expansion of corporations from Germany, the United Kingdom and the United States is emphasized by Alfred D. Chandler, Jr., Scale and Scope: The Dynamics of Industrial Capitalism (Cambridge, MA, Harvard University Press, 1990).

Notes (continued)

11/ See "Ongoing and future research: non-conventional transnational corporations" (E/C.10/1990/18).

12/ Charles Oman, "Changing international investment strategies in the North-South context", CTC Reporter, No. 22 (Autumn 1986), pp. 47-50, 55.

13/ See John Dunning, Explaining International Production (London, Unwyn Hyman, 1988), especially chap. 6.

14/ O. Agodo, "The determinants of U.S. private manufacturing investments in Africa", Journal of International Business Studies, No. 9 (Winter 1978), pp. 95-107; F. Scheneider and B. S. Frey, "Economic and political determinants of foreign direct investment", World Development, No. 13 (February 1985), pp. 161-175.

15/ Transnational Corporations and the Growth of Services: Some Conceptual and Theoretical Issues (United Nations publication, Sales No. E.89.II.A.5); Transnational Corporations, Services and the Uruguay Round (United Nations publication, Sales No. E.90.II.A.11).

16/ See E/C.10/1991/2.

17/ Louis T. Wells, Jr. and Alvin G. Wint, "Marketing a country: promotion as a tool for attracting foreign investment", unpublished paper, November 1988.

18/ "Do government policies toward foreign investment matter?" ...

19/ See E/C.10/1991/2.

20/ Stephen E. Guisinger, "Investment incentives and performance requirements: they matter", CTC Reporter, No. 20 (Autumn 1985), pp. 38, 40, 42; Trevor Farrell, "Incentives and foreign investment decisions: an opposing view", CTC Reporter, No. 20 (Autumn 1985), pp. 39, 41, 42; Louis T. Wells, Jr., CTC Reporter, No. 22 (Autumn 1986), pp. 58-60.

21/ Regional Economic Integration and Transnational Corporations in the 1990s: Europe 1992, North America, and Developing Countries (United Nations publication, Sales No. E.90.II.A.14).

22/ Suk H. Kim and Yoon K. Song, "US private investment in Korea", Columbia Journal of World Business, No. 22 (Winter 1987), pp. 61-66.

23/ Terutomo Ozawa, "Technology transfer and Japanese economic growth in the postwar period", in Research in International Business, vol. II (Greenwich, CT., JAI Press, 1981), Robert G. Hawkins and A. J. Prasad, eds., pp. 91-116; Alice Amsden, Asia's New Giant: South Korea and Late Industrialization (Oxford and New York, Oxford University Press, 1989), especially chap. 9. See also Transnational Corporations and the Transfer of New and Emerging Technologies to Developing Countries (United Nations publication, Sales No. E.90.II.A.20).

Notes (continued)

24/ See "Home country incentives for investment in least developed countries" (E/C.10/1990/4).

25/ Andrea Gubitz, "Impact of investment policies on German direct investment: an empirical investigation", World Bank working paper (forthcoming).